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July 29, 2002

EX PARTE – Via Electronic Filing

Ms. Marlene Dortch
Secretary
Federal Communications Commission
445 12th Street, S.W.
Washington, DC 20554

Re: Response to Verizon Letter of July 16, 2002 on TELRIC
CC Docket Nos. 01-338, 96-98, 98-147

Dear Ms. Dortch:

The attached letter was sent to Chairman Powell today.

In accordance with FCC rules, a copy of this letter is being filed electronically in the above-captioned dockets.

Sincerely,

/s/

Thomas M. Koutsky

/krs
Attachment

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July 29, 2002

<u>Ex Parte</u>

Hon. Michael K. Powell
Chairman
Federal Communications Commission
445 12th Street, S.W., Room 8-B201
Washington, DC 20554

Re: Response to Verizon Letter of July 16, 2002 on TELRIC
CC Docket Nos. 01-338, 96-98, 98-147

Dear Chairman Powell:

In his letter of July 16, Verizon's General Counsel, William Barr, asked you to reopen the rulemaking proceeding governing prices for network elements and enact rules that would substantially constrain the authority of state commissions. That plea contrasts starkly with the position Mr. Barr took previously with regard to the Commission's pricing rules. For example, in his oral argument to the Eighth Circuit in January 1997 Mr. Barr advocated exactly the opposite position, attacking the Commission for adopting pricing rules that were too specific. He said the Commission's pricing rules were defective because they "preordain[] the end result" and exemplify a "central planning philosophy" that failed to recognize the statutory role of the state commissions.[1]

There is, of course, little doubt why Mr. Barr and Verizon would so abruptly change their tune on the appropriateness of detailed FCC pricing rules. They twice lost before the Supreme Court.

[1] Transcript of oral argument, Jan. 17, 1997, *Iowa Utilities Board v. FCC*, No. 96-3321, at 20.

But the fact that Mr. Barr and Verizon now wish to take cover under the Commission's cloak does not mean that foisting new and prescriptive rules on the industry would be consistent with the statute or even a good idea. Indeed, Mr. Barr and Verizon are asking the Commission to usurp the role of the state commissions by establishing more detailed rules concerning the cost of capital, the appropriate treatment of depreciation, how to determine what technology is currently available, fill factors, and the treatment of non-recurring costs.

The Commission should reject this request to intrude on the authority reserved to the state commissions. Although the Commission has the authority to adopt rules interpreting the pricing provisions of the Act,[2] the Act clearly assigns to state commissions the duty to "establish any rates for . . . network elements."[3] The Commission therefore must recognize that its pricing rules cannot be so detailed that they fail to leave room for the state commissions to exercise their statutory authority.

Moreover, the state commissions are clearly better positioned than this Commission to conduct the detailed analyses necessary to establish rates. For example, as a practical matter this Commission would be unable to determine appropriate depreciation rates, fill factors, or the risk component of a risk-adjusted cost of capital for incumbents in fifty states. Issues such as those are appropriately resolved by state commissions because they are fact-intensive and their resolution requires detailed knowledge of the specific competitive conditions in the state. State commissions have formal hearing processes, which allow for sworn discovery, sworn testimony, and the opportunity for cross-examination. The Commission employs no such procedures in its rulemakings or in its tariff reviews. For similar reasons, state commissions have, in the pending Triennial Review, overwhelmingly argued that the Commission should not usurp the state role in making decisions of critical importance to the level of local competition in their states.

Mr. Barr paradoxically claims that reopening the pricing rules and adopting his proposals "will provide much-needed additional certainty and reduce the burden that these proceedings place on the resources of carriers and state commissions alike."[4] Nothing could be further from the truth. *Reopening the pricing rules would, instead, create uncertainty with respect to all of the UNE prices that have been set by state commissions over the last six years: uncertainty that will translate into less capital being invested by Verizon's competitors.*

As for the burden UNE rate proceedings place on state commissions, it is noteworthy that state commissions *themselves* are not seeking more guidance from the Commission. Indeed, they have consistently urged the Commission to adopt less-detailed rather than more-detailed pricing rules. Moreover, as the Supreme Court concluded, "TELRIC rate proceedings are surprisingly smooth-running affairs"[5] and all state commission determinations are subject to judicial review. Finally, as discussed below, Mr. Barr's letter contains, virtually verbatim, substantive arguments already made to and rejected by state commissions – with this letter, Mr. Barr and Verizon essentially want the Commission to usurp that process and act as an *ad hoc* court of appeal.

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[2] *AT&T v. Iowa Utilities Board*, 525 U.S. 366, 377-86 (1999).

[3] 47 U.S. C. § 252(c)(2).

[4] Letter or July 16, 2002, from William P. Barr to Chairman Michael Powell ("Barr letter") at 5.

[5] *Verizon Communications Inc. v. FCC*, 122 S. Ct. 1646, 1678 (2002).

Competitive carriers like Z-Tel are satisfied to go forward under the pricing rules that are in place rather than engaging in yet another round of litigation, which would inevitably follow from a new rulemaking proceeding. There is no good reason to reopen the pricing proceeding and upset the certainty created by the Commission's recent victory in the Supreme Court.

As to the merits of Mr. Barr's various proposals, it is clear that he is seeking to slam the door shut on competitive entry. First, Mr. Barr proposes to enlist the Commission as a partner in executing an anticompetitive price squeeze against new entrants serving the mass market, particularly residential customers. Enacting Verizon's new rules – particularly by changing cost of capital, depreciation schedules, and fill factors – would raise the price of network elements and leave untouched retail prices that in many states have been established by state commissions using those same or similar ratemaking tools. The net result would simply serve to withdraw competitive choices from consumers.

With respect to cost of capital, the arguments set forth in Mr. Barr's letter were made by Verizon nearly verbatim in numerous state proceedings, including Massachusetts and Florida.[6] Those state commissions rejected Verizon's arguments, and Mr. Barr is asking the Commission to circumvent the proper appeal process and reverse and preempt those decisions. In addition, Verizon proposes that the Commission guarantee monies Verizon is owed by bankrupt competitors by permitting Verizon to shift that bad debt into its UNE rates. That proposal would damage competitive entrants even further, while insulating incumbents from the current financial crisis. As with number portability, to the extent that there is any need for extraordinary cost recovery, which Verizon has not demonstrated, those costs of competition should be borne, if at all, by all customers.

In fact, it is impossible to reconcile Verizon's argument that its cost of capital should be adjusted upward to reflect the cost of capital of financially-distressed CLEC while Verizon seeks a governmental guarantee of its bad CLEC debt. A firm that can guarantee bad debt by force of law should have a much lower cost-of-capital than a firm in a competitive industry with no such guarantees.

It is also worth noting that the very fact that Verizon has proposed rules that amount to unilateral increases in UNE rates shows that Verizon has considerable market power over local network elements. In the *Triennial Review* proceeding, Verizon told the Commission that there has been "tremendous growth" in alternative local network facilities and "an explosion" in "alternatives for both broadband and narrowband services."[7] If that truly were the case, economics teaches that any increase in UNE prices would cause CLECs to cease placing orders for UNEs and provide service using those alternative facilities. Verizon would not collect the "bad debt" – it would be left holding the bag, and with stranded local network investment to boot. Verizon's profits would be noticeably lower than before.[8]

If, however, Verizon knew that it could increase UNE prices without causing CLECs to migrate customers to alternative local facilities – that is, if Verizon's local network elements are the only viable means

[6] *See, e.g.,* Verizon submission of March 5, 2002, in Massachusetts Docket No. 01-20, at 38, and Verizon submission of May 27, 2002, in Florida Docket No. 990649-TP, at 36.

[7] Verizon Reply Comments in CC Docket No. 01-338 at 1.

[8] *See* Declaration of George S. Ford, Attachment 1 to Z-Tel's Reply Comments in CC Docket No. 01-338, at ¶¶ 99-115.

of serving the mass market – then Verizon would be able to sustain and recover this price increase. Of course, the losers would be consumers and competitors, because the overall level of competitive entry predictably declines when UNE rates increase.[9] In fact, Verizon could recover such a price increase because of its dominant position in its local markets.

The incumbents' dominance in the local market contrasts sharply with the competitive interexchange market. Because there is a competitive wholesale market for interexchange services, companies like Z-Tel *and Verizon* may lease capacity rather than construct duplicative facilities to provide long-distance service. But the incumbents retain bottleneck control over the local exchanges, and TELRIC -- as implemented by the Commission and upheld by the Supreme Court -- permits new entrants to lease capacity to provide local service at rates comparable to those that would prevail if there were competitive local facilities. As we have emphasized in our comments in the *Triennial Review*, competitors like Z-Tel are therefore able to invest in software that provides innovative options to mass-market customers rather than in duplicative facilities that do not.

It is again ironic that Verizon now proposes to calculate prices for network elements using new entrants' costs of capital, which are much higher than incumbents', while at the same time vigorously asserting in the Triennial Review that incumbents cannot be required to share their economies of scale. It's heads Verizon wins, tails competition and consumers lose.

Mr. Barr's argument concerning the "extreme instantaneous and ubiquitous replacement approach" allegedly required by the Commission's pricing rules is also a restatement of an argument that was presented, virtually verbatim, to the Supreme Court, which rejected it.[10] In the incumbents' brief in the Supreme Court, they even used the same airline hypothetical repeated on pages 3-4 of Mr. Barr's letter. In its reply brief in the Supreme Court, the Commission rebutted that argument. The Commission first stated that the "incumbents assert that TELRIC assumes that a carrier would scrap its existing network and rebuild a new, more efficient one every time an advance in technology occurs," and explained that "TELRIC assumes no such thing."[11] With respect to the airline hypothetical Mr. Barr recycles, the Commission told the Court that "if new, more fuel-efficient aircraft were to become available, airlines would not necessarily respond by immediately replacing their older, less fuel-efficient aircraft," but that if an airline were to "lease its older aircraft, the price at which it could do so would be constrained by the cost of acquiring and operating the new aircraft."[12] The Commission should adhere to what it told the Supreme Court and the Court's decision upholding the Commission's pricing rules.

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[9] *See* T. Randolph Beard & George S. Ford, *Make or Buy? Unbundled Elements as Substitutes for Competitive Facilities in the Local Exchange Network*, appended as Attachment 3 to Z-Tel's Reply Comments in CC Docket No. 01-338.

[10] *See* Barr letter at 3; *Verizon*, *supra*, 122 S. Ct. at 1669-70.

[11] Reply Brief of the Federal Communications Commission and the United States, No. 00-511 *et al.*, *Verizon Communications, Inc. v. FCC*, at 7, 8.

[12] *Id.* at 8.

There is no need for this Commission to further instruct the states on how to determine prices for network elements. The states are fully competent to make those determinations and are not seeking further "guidance" from the Commission. Moreover, there is no merit to Mr. Barr's proposals, many of which are warmed-over and all of which are designed to raise the rates for leasing network elements in order to crush the mass-market competition that has recently emerged.

Sincerely,

/s/

Robert A. Curtis
President, Z-Tel Network Services

/s/

Thomas M. Koutsky
Vice President, Law and Public Policy

cc: Commissioner Kathleen Q. Abernathy
Commissioner Michael Copps
Commissioner Kevin J. Martin
Christopher Libertelli
Mathew Brill
Jordan Goldstein
Daniel Gonzalez
Dorothy Attwood
Jeffrey Carlisle
Michelle Carey
Tamara Preiss
Brent Olson